THE MICHIGAN LEGISLATIVE COUNCIL

Supplemental Report on the Feasibility and Cost-Effectiveness of a Consolidated State-wide Health Benefits System for Michigan Public School Employees'

October 11, 2005

Submitted by:
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Mr. John Strand
Council Administrator
Legislative Council, State of Michigan
P.O. Box 30036, Fourth Floor - Boji Tower
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Lansing, Michigan 48909-7536

Dear John:

On behalf of the Hay Group we are pleased to present our Supplemental Report on the Feasibility and Cost-Effectiveness of a Consolidated State-wide Health Benefits System for Michigan Public School Employees.

During the hearings on our Report on the Feasibility and Cost-Effectiveness of a Consolidated State-wide Health Benefits System for Michigan Public School Employees there were a number of questions about specific findings in the report. We addressed these at the hearings. Also, the Michigan Education Special Services Association (MESSA) issued an analysis of our reports on September 9, 2005.

Given the high level of interest in our report we believed it would be appropriate to address the questions in writing. Attached is our Supplemental Report which addresses these questions.

We are available to discuss the report with those interested in the results at your convenience.

Yours truly,

Edwin Hustead, FSA, EA, MAAA

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Tom Wildsmith

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Introduction

At the request of the Michigan Legislative Council the Hay Group prepared a Report on the Feasibility and Cost-Effectiveness of a Consolidated State-wide Health Benefits System for Michigan Public School Employees. We delivered the report on July 13, 2005 and have attended two hearings concerning the report. Questions and concerns about our report were raised at those hearings. While we provided answers at the hearings, we believe it is appropriate to record and elaborate on those answers.

The Michigan Education Special Services Association (MESSA) delivered an actuarial analysis of our report to the members of the Michigan Senate on September 8, 2005.

This supplemental report responds to questions raised at the hearings and in the MESSA report. As explained below, we did not find anything in the hearings or the MESSA report that would cause us to change the estimates in our July 13, 2005 report.

Our report included an Appendix A of those school districts responding to our survey. The initial version of the report did not include a complete list of the respondents but a corrected version did include a complete list. The complete list is also attached to this report.

The Hay Report presented and analyzed the potential effect of three alternative state-wide systems. These were:

1. A system that would provide all employees with the same level of benefits as they currently have.

2. A system that would provide five state-wide options along with Health Maintenance Organizations (HMOs) where available.

3. A system that would provide three state-wide options along with HMOs. The important difference between options 2 and 3 is that traditional fee-for-service (FFS) plans would not be available under option 3.

There would be no substantive change in the collective bargaining process for option 1 because all current plans would be available to the school districts and employees. (If participation in the state-wide system were mandatory, then districts would not have the power to negotiate over the insurer used. No other aspect of the collective bargaining process would be affected.)

The primary change in the collective bargaining process for options 2 would be that there would be a limited number of design choices available to the employees and employers of each school district. Other aspects of the health plans would still be subject to collective bargaining to the extent that they are in the current system. These include:

- The share of the premium charged to the employees and to the school district
- The definition of which employees would be covered by the plan.
- The design and cost-sharing of dental and vision benefits. The state-wide system would offer dental and vision benefits but school districts would be free to select other dental and vision benefits.
- The ability to offer cash in lieu of health benefits to employees and the flexibility to set the amount of cash.

The share of the savings between the school district and the employees deriving from a state-wide plan would also be subject to the current collective bargaining arrangements. If, for instance, a school district were to save $1,000,000 as a result of the state-wide plan, the portion of that used to reduce premiums for school employees would be determined through the current collective bargaining agreements.

A number of questions and concerns were also raised about the speed with which a state-wide plan could be established and the cost of administering the system. Our recommendation is that the duties of the Michigan Public School Employees Retirement System (MPSERS) be expanded to cover school employees as well as school retirees. MPSERS informed us that an equivalent of five full-time (FTE) employees is allocated to running the health plan for retired school employees. Given that the school employees are about double the retired employees we believe that the current MPSERS operation would only have to be increased by around ten FTE. At approximately $75,000 a person, including benefits and other factors, the annual cost for the administration would be $750,000. There would be additional costs in expanding existing MPSERS, such as initial program design, establishing administrative and accounting processes, and outreach and communications, but we believe that an additional start-up cost of $3,000,000 with half of that cost used before the year of start-up would be reasonable. MESSA estimates that start-up costs would be $4,200,000 which, given the long-term savings, is a fairly modest difference.

Our report considered the alternative of forming a new agency to administer the state-wide school employees system. However, given the fact that MPSERS already exists, is entrusted with administering coverage to retired school employees and covers a group of retirees similar in distribution to the employees we believe that expanding MPSERS is by far the best choice for administration.

One concern raised at the hearings was that it is a very complex and time-consuming process to establish a preferred-provider organization (PPO) or point-of-service organization (POS) for a large group of employees in a wide-spread geographic area. As with other aspects of the administration we believe that an advantage of MSPERS is that they already have a PPO network established and that expanding this state-wide network to employees throughout the state of Michigan should be much easier than starting afresh to establish PPO and POS networks. Given the pre-existing MPSERS PPO network, we believe that the appropriate networks for this program could be established by MSPERS within the year start-up time that we included in our implementation time table.

Removing non-eligible employees and dependents

From the perspective of an individual health plan, the frequency and timeliness of changes to the eligibility file have little, if any, impact on the operations of the plan. For example, when a family has one dependent child over age 18 who is no longer eligible for coverage as a full-time student, the family's health coverage would need to change from "family" to "employee plus spouse". This would result in a lower premium paid to the health plan as well as lower expected costs incurred by the health plan.

Our charge was to examine the operations of a consolidated state-wide health care system for school employees, and from this perspective, changes in the total premium paid by the school system to the health plans would reduce the overall expenditures of the system.

Accordingly, improvements in the management of the eligibility system, such as those outlined in our report as well as the improvements implemented by the Detroit Public School system, have a meaningful impact on the overall cost to the system.

Negotiated administrative fees

The MESSA analysis misunderstands the method we used in estimating the likely savings to be gained from negotiating administrative fees.

For option one, we did not assume that the current cost of administering the groups insured by MESSA would be reduced. We did, however, assume that a state-wide program would be able to reduce the administrative cost for other insured groups to the level reported for MESSA. We also assumed that the administrative cost for self-funded groups – which is currently significantly below that for MESSA – would not be increased. Reducing the administrative costs for other insured groups to the level reported by MESSA reduces the overall average administrative load from 7.43 percent to 7.30 percent, producing a system-wide cost reduction of 0.11 percent.

In estimating the administrative fees likely under options two and three, we carefully examined the administrative fees paid by self-insured school districts in Michigan, as well as those paid by the Michigan Civil Service program and MPSERS. It is important to note that the structure of a self-insured plan focuses negotiations on administrative fees in a way that fully insured contracts, where the fees are simply one more component of an overall premium, do not.

Currently, self-insured school districts are paying 6.2 percent of premium on average for administration. Larger self-funded programs, such as Civil Service, are able to negotiate significantly lower fees. Because the systems under discussion in options 2 and 3 would have to administer 5 plans, rather than one or two, we did not estimate that they would achieve the same level of negotiated savings as the Civil Service plan. We do believe it is reasonable to expect a level of savings slightly greater than that achieved by self-funded school districts negotiating on their own. Thus, we believe that an estimate of 6 percent is appropriate.

If one were to assume a state-wide system could not negotiate lower fees than those currently paid by self-funded school districts, and used an estimated administrative fee of 6.2 percent, the resulting system-wide savings would be 1.06 percent, rather than 1.23 percent. We do not believe it would be appropriate to use an estimated administrative cost greater than 6.2 percent for a state-wide, self-funded system offering a limited menu of plan choices, because that would imply that such a system could not negotiate fees as effectively as a single school district negotiating independently.

Provider Access Fees

The MESSA analysis asserts that there are no potential provider access fee savings available to any districts that currently have coverage through MESSA, or more generally, through BCBSM. It is important to note that most MESSA groups have traditional indemnity coverage, rather than network based coverage. Less than a quarter of the estimated provider access fee savings are attributable to groups covered through MESSA. The primary reason given is that the BCBSM provider access fee is bundled into the overall administration fee, which does not vary by number of enrollees.

For self-insured plans, the provider access fee is a separate charge. The fees are only bundled for insured plans. A large, aggressively managed state-wide program can clearly negotiate lower provider access fees; the state Civil Service program has done so. The level of provider access fees we used in developing our estimates of the cost of a statewide system is not hypothetical – we used the actual fee level negotiated by the Civil Service system. A unified school employees' system would have a larger enrollment, and thus might be able to negotiate even lower fees than the current Civil Service system. Thus, significant savings are clearly available for self-insured plans.

Savings are also available for plans that are currently insured. The state-wide system being studied would move these plans to self-funding. The provider access fee would no longer be bundled, and these plans would pay the same, lower, fee discussed above. This savings is not reflected in the negotiated administrative fee savings discussed above; those savings are based on the general administrative fees paid by predominantly non-network plans under alternative funding methods.

The MESSA analysis also asserts that provider access fees will actually result in a cost *increase* under Option 3, because more school employees would be enrolled in PPO plans, increasing the number of access fees paid. This seriously mischaracterizes the situation. Moving from a traditional indemnity plan to a PPO plan significantly reduces premiums under the current system. Moving a PPO plan into a state-wide system with lower negotiated provider access fees further reduces premiums. Increased use of network-based PPO plans will not increase the cost of providing benefits – the savings from provider discounts far outweighs the cost of provider access fees.

Prescription Drug Savings

Our report shows that substantial savings can be achieved through carving out prescription drug benefits and contracting directly with a Pharmacy Benefit Manager (PBM). A single pharmacy contract can ensure comparability of benefits across all medical delivery systems (Traditional indemnity, PPO, POS, and HMO) facilitating ease of communication to members, and can more rapidly address the introduction of new medications and cost control when brand named drugs go off patent protection.

Furthermore, a single contract covering all school employees and their families would have significant purchasing power that can be used to reduce the cost of the program without changing the level of benefits.

By way of illustration of the effectiveness of carving out and contracting directly with PBMs, we drew upon the recent experience of the Commonwealth of Pennsylvania health plan. Pennsylvania state employees' health benefits are administered by the Pennsylvania Employee Benefits Trust Fund (PEBTF), a fund with equal representation of labor and management trustees.

In April 2005, PEBTF rebid the pharmacy benefit administration. As part of the bidding process, PEBTF required the PBMs to reprice the last quarter's actual claims using each vendor's pricing structure. This process captures the net cost of the coverage taking into account guaranteed discounts from average wholesale price, pharmacy manufacturers' rebates, dispensing fees and all other costs and rebates. The rebid resulted in the selection of a new carrier with actual costs 26 percent lower than the prior contract.

The prior contract had the following parameters:

TABLE 1

	PEBTF 2004 Contract
Dispensing Fees	
• Retail	$2
• Mail Order	$1
Rebates	
• Retail	$1.75
• Mail Order	$4.75
• Combined	$2.25
AWP Discounts	Actual Realized
• Retail	27%
• Mail Order	33%

By comparison, as shown in Table 2.10 of the July 13, 2005 Hay report, the BCBSM contract (which is used by MESSA) had mail-order discounts of only 23 percent. Furthermore, MESSA reported that only 40 percent of scripts filled at retail were for generic drugs, compared with rates of 48 percent for BCBSM enrollees and 50 percent for Detroit Public School enrollees.

As the large majority of Michigan school employees were covered in pharmacy benefit arrangements that were not as cost efficient as the PEBTF 2004 contract, and the April 2005 rebid obtained a rollback of costs of 26 percent, we are confident that a state-wide contract covering all Michigan school employees would be able to lower the costs by at least 15 percent. All of these savings are achieved through contract negotiation so none of these savings are achieved by shifting costs to members in the form of higher copayments.

Durable Medical Equipment (DME) Savings

Using a similar process to prescription drugs, by carving out the durable medical equipment purchases from the individual plans, establishing a single contract, and competitively bidding the contract, Michigan would be able to reduce the cost without changes to the coinsurance levels.

Prior to 2005, PEBTF had several DME contracts in place. In 2005, the PEBTF consolidated all DME purchases under a single contract. Estimated savings from this consolidation are $1 million/year on a total healthcare expenditure of $500 million, equivalent to savings of 0.2 percent. As a consolidated healthcare system covering all Michigan school employees would have greater purchasing power with a larger number of covered lives than the PEBTF, we are confident that the savings achieved through DME purchasing would be at least as great as those achieved in Pennsylvania.

Audits

Whenever the health plan enters into a contract with specific terms and conditions (e.g. prescription drug discounts), the full level of savings from these contracts can best be assured through an enforcement mechanism. An audit is the preferred method of ensuring contract terms and conditions are met. An audit could use a sampling process or a complete audit of all claims. Where a sampling process is used, the contracts would include provisions to settle the financial differences between contract and actual practice by adjusting the results from the sample to the full claims experience.

In addition, we believe the Michigan school employees health system is large enough to employ a full time benefits analyst who, using monthly claims tapes, could carry out a complete audit of the prescription drug claims:

- The audit would compare actual copayments, rebates, dispensing fees, etc., against the contract provisions
- Discrepancies between actual claim administration and the contract provisions would be sent to the PBM, resulting in refunds to the Michigan school employees health plan

Based on the experience from the Commonwealth of Pennsylvania, we would expect recovery proceeds far in excess of the cost of the audit.

Stabilization Reserves

Well run health plans require a stabilization reserve to cover years in which benefits are higher than expected. The level of the reserve varies by many factors including the size of the plan, the insured status and the ability to make accurate projections of cost.

The stabilization reserve is usually increased each year in line with health costs. In a year with higher than expected costs the reserve is used to cover those higher costs. In a year with lower than expected costs the reserve increases by the amount of the difference in addition to any additional contribution to the stabilization reserve.

The stabilization reserve is only designed to protect the fund for the current premium year. Premiums are then raised at the beginning of the next year to cover expected cost increases and any variation in the stabilization reserve. If the stabilization reserve is drawn down in one year as a result of higher than expected costs, then premiums are increased in the next year to restore the stabilization reserve to the desired level. In some cases the reserves are restored over two or three years to avoid sharp increases in premiums.

If the stabilization reserve is higher than the target because of favorable experience then the excess in the reserve is used to reduce premium increases over the next few years.

We added a stabilization reserve of 4 percent of expected premiums each year and believe this is sufficient for a state-wide system. We also assumed that a full 4 percent reserve would be established during the first year of operation. MESSA suggests that, for a mandatory program, a reserve of 9.3 percent after four years of operation would be more reasonable. Of course, Michigan could work with MPSERS to provide a letter-of-credit arrangement that would require no reserve.

MESSA also commented that it would be important to have a larger reserve in the start-up years. In fact, we believe the opposite is the case. The total premium under the plan will grow rapidly from \$2.2 billion to \$3.3 billion from the first through the fourth year of operations. Any differences between actual and expected costs in the early years will be more than offset by growth in income that will ensure a positive cash flow. Differences between actual and expected experience can then be introduced in successive premiums without any risk to the plan itself. Significantly, the MESSA discussion assumes that the 9.3 percent reserve they recommend would be accumulated at a rate of 2.03 percent each year – which would result in a first year reserve that would be approximately half that assumed in our modeling.

In fact, the level of the reserve has little impact on the long-term savings in the system. The following tables compare the results of using a 4 percent or a 9.3 percent reserve level. These show both the flow of funds and the operations of the reserve. MESSA stated that our report did not include enough details to explain some of our calculations. We hope that the following two tables will address that concern.

MESSA stated that our report had assumed that "investment income should be sufficient to cover the required increases in later years..." In fact, we did not assume that there would be any investment income in our report. If we had assumed investment income our projected total savings would have been larger.

TABLE 2
FIVE YEAR PROJECTED SAVINGS WITH 4% RESERVE FACTOR

Year	Savings	Start-up Administrative Cost in Year	Premium in Year	Reserves	Increase in Reserve	Total Savings in year *
FY 2005/2006	-	$1,500,000				$ (1,500,000)
FY 2006/2007	$280,653,178	1,545,000	$2,164,358,412	$ 86,574,336	$86,574,336	192,533,841
FY 2007/2008	383,095,914	1,591,350	2,954,382,599	118,175,304	31,600,967	349,903,597
FY 2008/2009	408,242,958		3,148,313,116	125,932,525	7,757,221	400,485,737
FY 2009/2010	428,655,106		3,305,728,772	132,229,151	6,296,626	422,358,480

TABLE 3
FIVE YEAR PROJECTED SAVINGS WITH 9.3% RESERVE FACTOR

Year	Savings	Start-up Administrative Cost in Year	Premium in Year	Reserves	Increase in Reserve	Total Savings in year*
FY 2005/2006	-	$1,500,000				$(1,500,000)
FY 2006/2007	$280,653,178	1,545,000	$ 2,164,358,412	$201,285,332	$201,285,332	77,822,845
FY 2007/2008	383,095,914	1,591,350	2,954,382,599	274,757,582	73,472,249	308,032,315
FY 2008/2009	408,242,958		3,148,313,116	292,793,120	18,035,538	390,207,420
FY 2009/2010	428,655,106		3,305,728,772	307,432,776	14,639,656	414,015,450

* Savings less start-up administrative costs less increase in reserves.

Subsidies for Medicare Supplement

Insured health plans in Michigan pay a Medicare Supplemental charge as part of their premium. Self-insured plans do not have to pay such a charge. Therefore, establishing a state-wide self-insured plan would reduce the costs of the program by the Medicare Supplement now being paid by insured plans for school employees.

The MESSA report notes that the savings associated with removing the Medicare Supplemental Charge could be achieved if the State were to eliminate the charge on insured plans. While that may be the case, our charge was to determine the savings that would result from moving from the current system to a state-wide system. We believe including the savings that would result from reducing the cost by the amount of the supplemental charge now levied on school employees' health insurance is appropriate.

APPENDIX
List of Respondents

Akseda Public Schools
Allegan ISD
Allendale Public School District
Alma Public Schools
Alpena Public Schools
Armada Area Schools
Athens Area Schools
Bark River-Harris School District
Barry ISD
Beal City Public Schools
Bear Lake School District
Benton Harbor Area Schools
Benzie County Central Schools
Berkley School District
Big Rapids Public Schools
Birch Run Area School District
Birmingham City School District
Bloomfield Hills School District
Boyne City Public Schools
Branch ISD
Brighton Area Schools
Britton-Macon Area School District
Bronson Community School District
Brown City Community Schools
Bullock Creek School District
Byron Area Schools
Byron Center Public Schools
C.O.O.R. ISD
Calhoun ISD
Camden-Frontier Schools
Carman-Ainsworth Community Schools
Carrollton School District
Carson City-Crystal Area Schools
Casman Alternative Academy
Cedar Springs Public Schools
Center Line Public Schools
Charlevoix Public Schools
Charlevoix-Emmet ISD
Charlotte Public Schools
Chassell Township School District
Chiplewa district School
Chippewa Hills School District
Clare-Gladwin RESD
Clarkston Community School District
Clawson City School District
Clinton Community Schools
Clinton County RESA
Coldwater Community Schools
Comstock Public Schools
Constantine Public School District
Coopersville Public School District
Copper Country ISD
Corunna Public School District
Crawford AuSable Schools
Crestwood School District
Davison Community Schools
Dearborn Heights School District #7
Deckerville Community School District
Delta-Schoolcraft ISD
Detroit City School District
DeWitt Public Schools
Dowagiac Union School District
Dundee Community Schools
Durand Area Schools
East Grand Rapids Public Schools
East Jordan Public Schools
East Lansing School District
Eastern Upper Peninsula ISD
Edwardsburg Public Schools
Ellsworth Community School
Engadine Consolidated Schools
Escanaba Area Public Schools
Farmington Public School District
Fennville Public Schools
Flat Rock Community Schools
Flushing Community Schools
Forest Park School District
Fowler Public Schools
Fowlerville Community Schools
Fruitport Community Schools
Galien Township School District
Genesee ISD
Gibraltar School District
Gladstone Area Schools
Godfrey-Lee Public Schools
Grand Haven Area Public Schools
Grand Ledge Public Schools
Grand Rapids Public Schools
Gratiot-Isabella RESD
Gull Lake Community Schools
Gwinn Area Community Schools
Hale Area Schools

Hamilton Community Schools
Hancock Public Schools
Hanover-Horton Schools
Harbor Beach Community Schools
Harbor Springs School District
Harper Creek Community Schools
Hartland Consolidated Schools
Haslett Public Schools
Hesperia Community Schools
Hillman Community Schools
Hillsdale ISD
Homer Community Schools
Houghton-Portage Township Schools
Howell Public Schools
Huron School District
Huron Valley Schools
Imlay City Community Schools
Ingham ISD
Inland Lakes Schools
Ionia ISD
Iron Mountain Public Schools
Ishpeming Public School District
Jackson ISD
Jenison Public Schools
Kalamazoo R.E.S.A.
Kaleva Norman Dickson School District
Kearsley Community Schools
Kelloggsville Public Schools
Kenowa Hills Public Schools
Kentwood Public Schools
Lake City Area School District
Lake Fenton Community Schools
Lake Linden-Hubbell School District
Lakeshore School District (Berrien)
Lakeview Community Schools (Montcalm)
Lakeview Sch. District (Calhoun)
Lakeville Community Schools
L'Anse Creuse Public Schools
Lansing Public School District
Lapeer ISD
Lenawee ISD
Les Cheneaux Community Schools
Leslie Public Schools
Lincoln Park Public Schools
Litchfield Community Schools
Lowell Area Schools
Ludington Area School District
Mancelona Public Schools
Manistee ISD
Manistique Area Schools
Marion Public Schools
Marquette Area Public Schools
Marysville Public Schools
Mason County Central Schools
Mason Public Schools (Ingham)
Mason-Lake ISD
Mayville Community School District
Mecosta-Osceola ISD
Melvindale-North Allen Park Schools
Menominee ISD
Michigan Center School District
Midland County ESA
Midland Public Schools
Milan Area Schools
Mio-AuSable Schools
Mona Shores Public School District
Montague Area Public Schools
Montcalm Area ISD
Morley Stanwood Community Schools
Mt. Pleasant City School District
Muskegon Area ISD
Muskegon City School District
Muskegon Heights School District
Napoleon Community Schools
Newaygo County RESA
Newaygo Public School District
North Dickinson County Schools
Northville Public Schools
Oakland Schools
Oceana Intermediate School District
Olivet Community Schools
Orchard View Schools
Oscoda Area Schools
Parchment School District
Pennfield School District
Pentwater Public School District
Perry Public School District
Pewamo-Westphalia Community Schools
Pinckney Community Schools
Plainwell Community Schools

Plymouth-Canton Community Schools
Port Huron Area School District
Portland Public School District
Public Schools of Petoskey
Rapid River Public Schools
Reading Community Schools
Reed City Area Public Schools
Reese Public Schools
Reeths-Puffer Schools
Richmond Community Schools
Rochester Community School District
Rockford Public Schools
Romeo Community Schools
Romulus Community Schools
Saginaw ISD
Saginaw Township Community Schools
Sandusky Community School District
Sault Ste. Marie Area Schools
Shelby Public Schools
Shiawassee Regional ESD
South Haven Public Schools
South Lake Schools
South Lyon Community Schools
Spring Lake Public Schools
St. Joseph County ISD
St. Louis Public Schools
Standish-Sterling Community Schools
Stephenson Area Public Schools
Stockbridge Community Schools
Sturgis Public Schools
Summerfield School District
Superior Central Schools
Swan Valley School District
Swartz Creek Community Schools
Three Rivers Community Schools
Traverse City Area Public Schools
Trenton Public Schools
Tri County Area Schools
Troy Community School
Troy School District
Tuscola ISD
Union City Community Schools
Unionville-Sebewaing Area S.D.
Utica Community Schools
Waldron Area Schools
Walled Lake Consolidated Schools
Waterford School District
Wayne RESA
Wayne-Westland Community School District
West Bloomfield School District
Westwood Community Schools
White Cloud Public Schools
White Pigeon Community Schools
Whiteford Agricultural Schools
Whitehall District Schools
Whitmore Lake Public Schools
Whittemore Field High Schools
Willow Run Community Schools
Wyandotte City School District
Wyoming Public Schools
Yale Public Schools